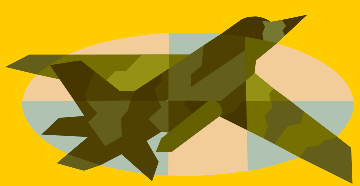
Decide with Confidence

Accounting for Fixed Assets



Agenda

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- Property Plant and Equipment (IAS 16)
- Intangible Assets (IAS 38)
- Impairment (IAS 36)
- Investment Property (IAS 40)
- Leases (IAS 17)

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Property, plant and equipment
IAS 16

PPE – important points

- Definitions
- Measurement and recognition
- Subsequent measurement
- Depreciation
- Derecognition
- Impairment
- Disclosures

Definitions

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- **Carrying amount** is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

- **Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

Definitions

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- **Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.
- **Depreciation** is the systematic allocation of the depreciable amount of an asset over its useful life.
- **Fair value** is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.
- **An impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Definitions

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- **Property, plant and equipment** are tangible items that:
  - are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
  - are expected to be used during more than one period.
- **Useful life is:**
  - the period over which an asset is expected to be available for use by an entity; or
  - the number of production or similar units expected to be obtained from the asset by an entity.

Definitions

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- **Recoverable amount** is the higher of an asset's net selling price and its value in use.

- The **residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Measurement and recognition

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- **The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:**
  a) It is probable that future economic benefits associated with the item will flow to the entity, and
  b) The cost of the item can be measure reliably.

- **Revenue item that may reduce the cost of PPE**
  a) Internal profits for self constructed assets to be eliminated
  b) govt. grants reduce carrying amount

- **Excluded from the standard**
  - asset held for sale - IFRS 5
  - biological assets relating to agricultural activity
  - mineral rights and reserves
  - investment property - IAS 40

- Spare parts are carried ***as inventory*** and charged to income statement as consumed.
- Major spare parts ***qualify as PPE*** when an entity expects to use them during more than one period.
- If the spare parts can be used only with an item of property, plant and equipment, they are ***accounted for as property, plant and equipment***.

Measurement and recognition

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- **Initial measurement**

  PPE is initially measured ***at cost***. This comprises costs directly attributable to acquiring the asset (purchase price) and the costs necessary to bring such an asset to the location and working condition for its intended use.

- **Measurement of cost**

  The cost of an item of property, plant and equipment is the ***cash price equivalent*** at the recognition date.

Measurement and recognition
Cost of the Asset

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a) Purchase price, import duties, non-refundable taxes, less trade discounts and rebates

b) Directly attributable costs

   a) costs of employee benefits arising directly from the construction or acquisition of the item of property, plant and equipment;

   b) costs of site preparation;

   c) initial delivery and handling costs;

   d) installation and assembly costs;

   e) Testing costs

   f) professional fees.

c) Borrowing costs as recorded as per IAS 23

d) Initial estimate of cost of dismantling

Borrowing costs (IAS 23)

- General rule, borrowing costs have to be expensed
- Alternative treatment
- borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset shall be capitalized as part of the cost of that asset
- Borrowing costs include
  - interest
  - other costs incurred by an entity in relation to borrowing of funds
  - exchange differences arising from foreign currency borrowing to the extent that they are regarded as an adjustment to interest costs.

Borrowing costs (IAS 23)

- If both the following conditions are met
  - It is probable that they will result in future economic benefits to the entity.
  - The costs can be measured reliably

- Qualifying Asset
  - one that necessarily takes a substantial period of time to get ready for its intended use or sale.

Capitalisation of borrowing costs

- Specific borrowing costs
- General borrowing
  - weighted-average capitalization rate considering all the general borrowings outstanding during the period
- Borrowing costs to be reduced by any investment income resulting from the investment of idle funds
- Capitalization ceases when the asset is ready for use (actual use is immaterial)

Asset Retirement Obligation

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- Decommissioning, restoration and similar liabilities
- Legal or constructive obligation
- Requires managements best estimate of costs
- Estimate has to be based on present obligation
- If it is not clear whether a present obligation exists,
  - the entity may evaluate evidence under "more like than not" threshold
  - the threshold is in relation to the likelihood of settling the obligation
- Present Value of obligations
  - Take pre-tax discount rate reflecting risks and TVM
  - Present Value of cost included as part of related PPE
- Simulataneously the Liability is created

- in Indian GAAP, the treatment is similar but discounting is not required and indirect reference is for capitalisation in standard related to provisioning

Costs not included in the cost of PPE

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- Costs of opening a new facility (often referred to as preoperative expenses)
- Costs of introducing a new product or service
- Advertising and promotional costs
- Costs of conducting business in a new location or with a new class of customer
- Training costs
- Administration and other general overheads
- Costs incurred while an asset, capable of being used as intended, is yet to be brought into use, is left idle, or is operating at below full capacity
- Initial operating losses
- Costs of relocating or reorganizing part or all of an entity’s operations
- Interest paid to the supplier

Measurement of Cost

- The cost of an asset is measured at the cash price equivalent at the date of acquisition.
- What if the payment is deferred beyond normal credit terms?
- If payment is “deferred” beyond normal credit terms
- Diff. between cash equivalent and nominal consideration is recognized as interest revenue
- What is the asset is acquired in exchange for another asset?
- If an asset is acquired in exchange for another asset
  - Cost is measured at fair value
  - Unless the exchange lacks commercial substance or the fair value cannot be reliably measured
  - In such cases, the cost will be the cost given up

Subsequent measurement

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- **Subsequent expenditure**

  Such costs should be added when

  - it is probable that future economic benefits, exceeding the original standard of performance, will flow to the entity
  - can be reliably measured.

- What about regular major inspection or overhaul?

- The cost of major inspection or overhaul occurring at regular intervals is capitalised where
  - it is identified as a separate component of the asset and
  - the replaced components are fully depreciated.

Subsequent measurement

- **Measurement after recognition**

  An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

  –**Cost Model**

  –**Revaluation Model**

Subsequent measurement

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– **Cost Model**

the cost of the asset

(less) accumulated depreciation

(less) accumulated impairment losses

– **Revaluation Model:**

revalued amount (being its fair value at the date of the revaluation)

(less) any subsequent accumulated depreciation

(Less)subsequent accumulated impairment losses.

Subsequent measurement – Cost Model

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Depreciation

– Each item of property, plant and equipment shall be depreciated.
– Depreciation charge for each period shall be recognised in profit or loss.
– The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.
– ***The residual value and the useful life of an asset shall be reviewed at least at each financial year-end*** and, if expectations differ from previous estimates, the change shall be accounted for as a ***change in an accounting estimate*** in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Subsequent measurement – Cost Model

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– **Componentisation is required**

- Different useful lives and depreciation rates can be used for different components
- For Example, for an aircraft
  - – Wings
  - – Airframe
  - – Engines
  - – Seats etc.

Subsequent measurement – Cost model

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Depreciation

- The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- The ***depreciation method applied to an asset shall be reviewed at least at each financial year-end*** and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the ***method shall be changed to reflect the changed pattern***. Such a change shall be accounted for as a ***change in an accounting estimate*** in accordance with IAS 8.

Subsequent measurement

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- ***If an item of property, plant and equipment is revalued, the entire class to which that asset belongs shall be revalued.***
- A ***class*** of property, plant and equipment is a ***grouping of assets of a similar nature and use*** in an entity's operations. Example:
  - land;
  - land and buildings;
  - machinery;
  - ships;
  - aircraft;
  - motor vehicles;
  - furniture and fixtures; and
  - office equipment.

Subsequent measurement

- Items ***within a class*** of property, plant and equipment are ***revalued simultaneously*** to avoid selective revaluation of assets.
- If an asset's carrying amount is increased as a result of a revaluation, the increase shall be credited directly to equity under the heading of ***revaluation surplus***. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.
- If an asset's carrying amount is ***decreased*** as a result of a revaluation, the decrease shall be ***recognised in profit or loss***. However, the decrease shall be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Basis of Revaluation

- Land and Buildings - Generally market value
- PPE - Generally market value
- PPE - If specialized, Depreciated replacement cost

- Depreciation for each year needs to be provided for before revaluation
- Revaluation surplus, in excess of previously expensed impairment loss, to be directly credited to equity as revaluation surplus
- Subsequently, if carrying amount decreases, revaluation surplus should go down. If decrease in carrying amount is more than revaluation surplus for that asset, it should be charged as expense.

Derecognition

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- The carrying amount of an item of property, plant and equipment shall be ***derecognised***:
  - ***a) on disposal; or***
  - ***b) when no future economic benefits are expected from its use or disposal.***

- The ***gain or loss*** arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised. Gains shall not be classified as revenue.

Derecognition

- If an entity recognises in the carrying amount of an item of property, plant and equipment the ***cost of a replacement for part of the item***, then it derecognises the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately.
- The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

Disclosures

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- The financial statements shall disclose, for each class of property, plant and equipment:
  a) the measurement bases used for determining the gross carrying amount;
  b) the depreciation methods used;
  c) the useful lives or the depreciation rates used;
  d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and

Disclosures

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e) a reconciliation of the carrying amount at the beginning and end of the period showing:

i. additions;

ii. assets classified as held for sale;

iii. acquisitions through business combinations;

iv. increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in equity;

v. impairment losses recognised or reversed in profit or loss;

vi. depreciation; and

vii. other changes.

Disclosures

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- The financial statements shall also disclose:
  a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
  b) the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction; and
  c) the amount of contractual commitments for the acquisition of property, plant and equipment.

Disclosures

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- If items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed:
  a) the effective date of the revaluation;
  b) whether an independent valuer was involved;
  c) the methods and significant assumptions applied in estimating the items' fair values;
  d) the extent to which the items' fair values were determined by reference to observable prices in an active market or recent market transactions or were estimated using other valuation techniques;
  e) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and
  f) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

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Intangible Assets (IAS 38)

Intangible Asset

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- An identifiable non-monetary asset without physical substance
  - Patent, Copyright, Trademark, Brand
  - Expenditure on Design and implementation of new processes and systems
  - Licenses
  - Research and Development
  - Compact disc (in the case of computer software)
  - legal documentation (in the case of a licence or patent)
  - Motion Picture Film
  - Deferred Revenue Expenditure
  - Computer software
  - Customer lists
  - Mortgage servicing rights
  - Import quotas
  - Franchises
  - Market share and marketing rights

Intangible Assets

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Standard does not apply to

- Intangible assets held for sale in ordinary course of business (IAS 2)
- Deferred tax assets (IAS 12)
- Leases (IAS 17)
- Assets arising from employee benefits (IAS 19)
- Financial assets as per IAS 39
- Goodwill acquired in a business combination (IFRS 3)
- Intangible assets relating to Insurance (IFRS 4)
- Non-current assets held for sale (IFRS 5)

Identification of Intangible Asset

- when the asset is separable from the entity
- asset arises from legal or contractual right
- when entity controls such asset to give it power to obtain future economic benefits

- Control may be difficult to prove.
- So in case of skilled employees, customer relationships etc., these can be classified as intangible assets if an entity controls future economic benefits arising from it
- Can the customer relationship or market share be accounted as an intangible asset?

Initial Recognition of Intangible Asset

- **Recognition if and only if**
  - it is probable that future economic benefits will flow to the entity
  - cost can be measured reliably

Initial Measurement

- **At cost**
- **Cost of separately acquired intangible asset**
  - purchase price
  - import duties and non-refundable taxes - trade discounts and rebates
  - any directly attributable costs
- **Cost of asset acquired in the business combination**
  - its fair value
  - all identifiable assets can be recognized at fair value irrespective of whether acquiree had recognized them or not

Directly attributable costs of intangibles

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- costs of employee benefits (as defined in IAS 19) arising directly from bringing the asset to its working condition;
- professional fees arising directly from bringing the asset to its working condition
- costs of testing whether the asset is functioning properly.

Not a part of the cost of intangible assets

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- costs of introducing a new product or service (including costs of advertising and promotional activities)
- costs of conducting business in a new location or with a new class of customer (including costs of staff training)
- administration and other general overhead costs

- Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management

Subsequent Measurement

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- Cost Model
- Revaluation model

Identification of Useful life of Intangible Asset

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- the expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team
- typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way
- technical, technological, commercial or other types of obsolescence
- the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset
- expected actions by competitors or potential competitors
- the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the entity's ability and intention to reach such a level
- the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases
- whether the useful life of the asset is dependent on the useful life of other assets of the entity

Example

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- The broadcasting licence is renewable every 10 years if the entity provides at least an average level of service to its customers and complies with the relevant legislative requirements.
- The licence may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition.
- The acquiring entity intends to renew the licence indefinitely and evidence supports its ability to do so.
- Historically, there has been no compelling challenge to the licence renewal.
- The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future. Therefore, the licence is expected to contribute to the entity's net cash inflows indefinitely.
- What will be the useful life of the licence?

Research and Development Expense

- Research Costs Expensed
  - Activities aimed at obtaining new knowledge;
  - The search for, evaluation and final selection of, applications of research findings or other knowledge;
  - The search for alternatives for materials, devices, products, processes, systems or services; and
  - The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Research and Development Expense

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- Development Costs Capitalised if
  - technical feasibility completing the intangible asset
  - the intention to complete the intangible asset
  - the ability to use or sell it
  - how the intangible asset will generate future economic benefits - the entity should demonstrate the existence of a market or, if for internal use, the usefulness of the intangible asset
  - the availability of adequate resources to complete the development and
  - the ability to measure reliably the expenditure attributable to the intangible asset during its development

Research and Development Expense

Decide with Confidence

- Development Costs
  - design, construction and testing of pre-production or pre-use prototypes and models
  - design of tools, jigs, moulds and dies involving new technology
  - design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
  - design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Special Intangibles

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- Intangibles having Infinite life can not be amortised. They have to be tested for impairment
  - Brand
  - Goodwill
- Certain Intangibles have to be expensed, they can not be capitalised
  - Research Expenses
  - Advertising Expenses
  - Internally Generated Goodwill

Review of Amortization period and amortization method

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- at least at ***each financial year-end***

- If the expected useful life of the asset is different from previous estimates, the amortisation period shall be changed accordingly.

- If there has been a ***change in the expected pattern of consumption*** of the future economic benefits embodied in the asset, the amortisation method shall be changed to reflect the changed pattern.

- Treated as ***changes in accounting estimates*** in accordance with IAS 8.

Disclosures

Decide with Confidence

- For each class of asset, distinguishing internally generated and other asset
  - Useful life
  - Amortisation rate
  - Infinite life assets
  - Amortisation method
  - Gross carrying amount, amortisation and net amount
  - line items in the income statement in which amortization is included
  - Additions
  - Separately shown as acquired under business combinations
  - Assets classified as held for sale under IFRS 5

Disclosures

- Increases or decreases during the period resulting from revaluations
- Impairment losses
- Reversals of impairment losses
- Net exchange differences on retranslation
- Other changes during the period
- The existence and carrying amounts of intangible assets whose tile is restricted or pledged as security for liabilities
- Contractual commitments for the acquisition of intangible assets
- Intangible assets acquired by way of government grant and initially recognized at fair value, including their fair values, their carrying amounts, and whether subsequently carried under the cost or revaluation model

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Impairment

- IAS 36 applies to the assets other than
  - Inventories
  - assets arising from construction contracts
  - deferred tax assets
  - assets arising from employee benefits
  - financial assets that are within the scope of IAS 39
  - investment property that is measured at fair value
  - biological assets related to agricultural activity
  - deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts
  - non-current assets (or disposal groups) classified as held for sale

Impairment (IAS 36)

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- Impairment, as defined by IAS 36, is a situation that occurs when the **recoverable amount of an item declines below the carrying amount (NBV)**.

- The type of events that could lead to an impairment of an asset could be :
  a) External
  b) Internal
  c) Other

Impairment

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a) External factors
   - Significant decline in market value
   - Adverse change in: technology, economy, market, legal environment, etc.

b) Internal factors
   - Damage or obsolescence
   - Plans to discontinue/restructure operations
   - Economic performance of the machine is worse than expected

c) Other factors: cash flows for acquiring an asset or operating or maintaining it are significantly higher than budget

Example

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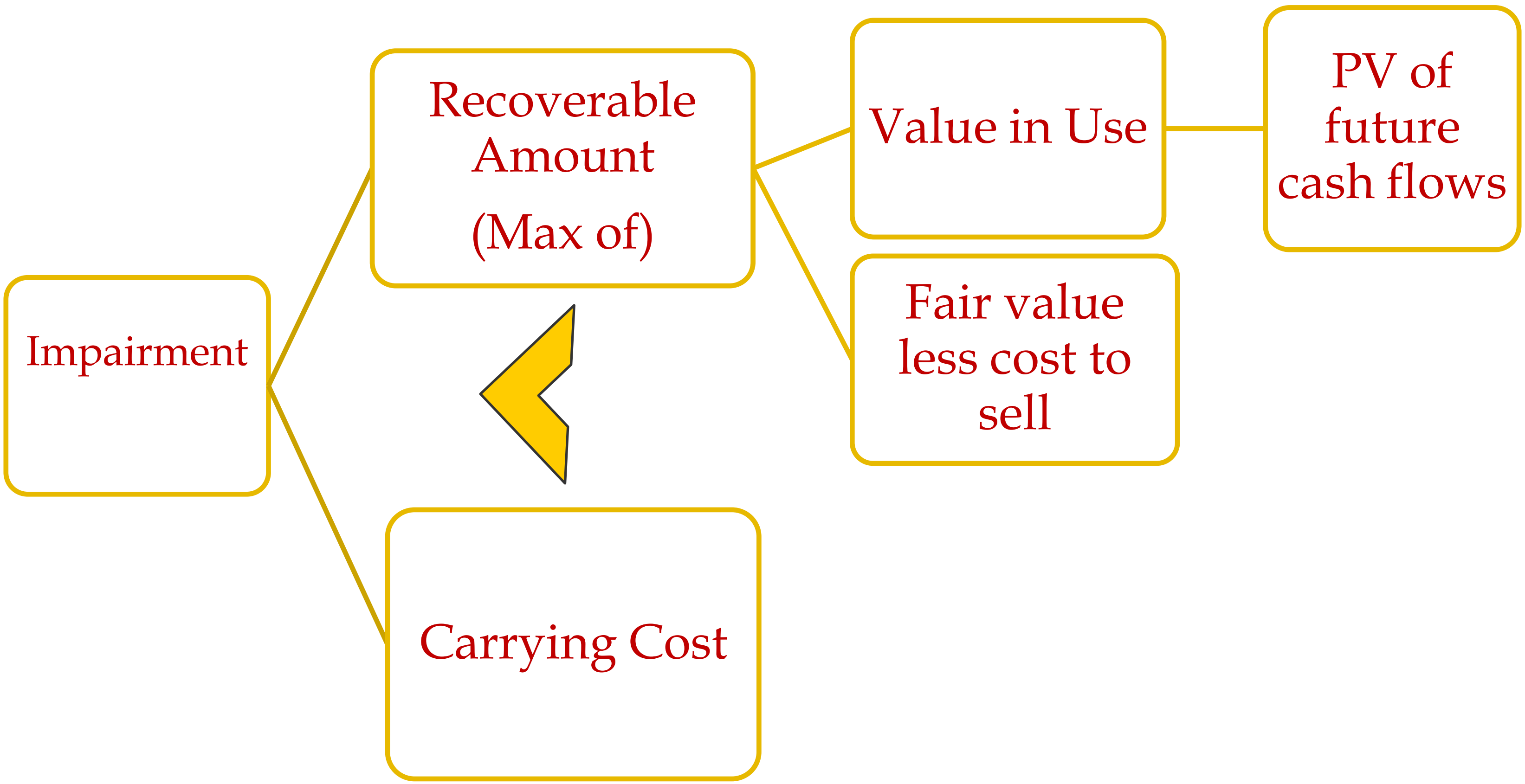
- An entity has purchased the whole of the share capital of another entity for a purchase consideration of Rs. 200 million.
- The goodwill arising on the transaction was Rs.50 million.
- It was planned at the outset that the information systems would be merged in order to create significant savings.
- Additionally the entity was purchased because of its market share in a particular jurisdiction and because of its research projects.
- Subsequently the cost savings on the information systems were made.
- The government of the jurisdiction introduced a law that restricted the market share to below that anticipated by the entity, and some research projects were abandoned because of lack of funding.
- What would be the accounting treatement?

Recoverable amount

- The **recoverable amount** of an asset or a cash-generating unit can be measured as the higher of
  - its **fair value less costs to sell** (the amount obtainable from the sale of an asset or ***cash-generating unit*** in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal)and
  - its **value in use** (present value of the future cash flows expected to be derived from an asset or cash-generating unit).

- If either of the above two amounts exceeds the asset's carrying amount, the asset is not considered for impairment.


Impairment
Recoverable Amount
(Max of)
Value in Use
PV of future cash flows
Fair value less cost to sell
Carrying Cost

Recoverable Value

- If it is not possible to determine the fair value less costs to sell because there is no active market for the asset, the entity can use the asset's value in use as its recoverable amount.
- If there is no reason for the asset's value in use to exceed its fair value less costs to sell, the latter amount may be used as its recoverable amount (e.g. in case the asset is held for disposal)

Value in Use

- **The elements to be used while calculating Value in Use**
  - Estimates of the future cash flows that the entity expects to get from the asset
  - Any possible variations that may occur in the amount or timing of the future cash flows
  - The time value of money represented by the current market risk-free rate of interest
  - The uncertainty inherent in the asset
  - Any other factors that should be borne in mind when determining the future cash flows from the asset

Value in Use – Future Cash flows

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- Based on reasonable and supportable assumptions
- based on the most recent financial budgets and forecasts
- Cash flows should not include any cash flows that may arise from future restructuring or from improving or enhancing the asset's performance
- **only a five-year period at maximum**
- **However, longer period is permitted if more reliable**
- Not to include inflows or outflows from financing activities or income tax receipts and payments
- include the estimated disposal proceeds from the asset
- Discounted at pretax rate that reflects current market assessments of the time value of money and the risks that relate to the asset

Example

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- An entity is reviewing one of its business segments for impairment.
- The carrying value of its net assets is Rs. 20 million. Management has produced two computations for the value-in-use of the business segment.
- The first value (Rs.18 million) excludes the benefit to be derived from a future reorganization, but the second value (Rs.22 million) includes the benefits to be derived from the future reorganization.
- There is not an active market for the sale of the business segments.
- Which one will you consider as a value in use????

Cash Generating Unit

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- A CGU is the smallest identifiable group of assets that generates cash inflows largely independent of cash inflows from other assets

- If an individual asset's recoverable amount can not be determined, is should be   grouped together in a CGU

Timing of the impairment test

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- Any time during the financial year provided the impairment test is carried out at the same time each financial year
- Different cash-generating units can be tested for impairment at different times of the year
- If CGU acquired under business combination, the impairment test needed before the end of current financial year

Reversal of Impairment

- To be assessed ***at each reporting date***, expect goodwill
- Consider the ***same sources*** as used for impairment testing
- External indicators suggesting reversal of impairment
  - ➢ significant increase in asset's market value
  - ➢ favorable changes in economic, legal, technological or market environment
  - ➢ decrease in market interest rates
- However, the increase in ***the carrying value of the asset can only be up to what the carrying amount would have been if the impairment had not occurred.***
- Reversal of CGU will be treated for the ***assets on pro rata basis***, except Goodwill

Disclosures

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- For each class of asset
  - Impairment losses recognized in the income statement
  - Impairment losses reversed in the income statement
  - The line item in the income statement in which the impairment losses are included

- For reversal of impairment
  - The events and circumstances leading to the impairment loss
  - The amount of the loss
  - If it relates to an individual asset, the nature of the asset and the segment to which it relates
  - For a cash-generating unit, the description of the amount of the impairment loss or reversal by class of assets and segment should be disclosed.
  - If the recoverable amount is fair value less costs to sell, the basis for determining fair value must be disclosed.
  - If the recoverable amount is the value-in-use, the discount rate should be disclosed.

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Investment Property

Investment Property (IAS 40)

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- Property held in order to earn rentals and/or capital appreciation
- It would include property being constructed or developed for future use as investment property.
- owner occupied property or property held for sale is excluded

Measurement

(a) fair value model

(b) depreciated cost model

If Fair Value model chosen,

✓the loss/gain on fair valuation goes to P&L

✓the property is not depreciated

Subsequent classification

- Transfers to and from investment property shall be **made *when and only when there is a change of use*** *evidenced*

- Investment property to be sold -- reclassified as inventory
- Investment property to be owner occupied – PPE
- PPE to Investment property

Disclosures

- Whether cost or revaluation model used
- When classification is difficult, the criteria used to distinguish investment property, owner occupied property and property held for disposal in the ordinary course of business
- The methods used and significant assumptions made in determining fair value
- The extent to which fair values are based on assessments by an independent and qualified valuer
- Amount recognised in income statement
  - Rental income from investment property
  - Direct operating expenses that generated rental income
  - Direct operating expenses that did not generate rental income
  - Cumulative change in fair value recognized in the income statement on sale of investment property from a pool of assets in which the cost model is used to a pool in which the fair value model is used
- Restrictions and contractual obligations

Additional disclosures for cost model

- Depreciation methods used
- Useful lives or depreciation rates used
- Reconciliation
- Assets classified as held for sale under IFRS 5
- Impairment losses
- Transfers to and from inventories and owner-occupied property
- The fair value of investment property and, if fair value cannot be reliably measured
  - Explanation as to why fair value cannot be reliably measured
  - Range of estimates, if possible, within which the fair value is highly likely to fall
  - Disposals of investment property not carried at fair value

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Non Current Assets Held for Sale and Discontinued Operations (IFRS 5)

Non current Assets held for sale and discontinued operations (IFRS 5)

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- **Held for sale.** The carrying amount of a noncurrent asset will be recovered mainly through selling the asset rather than through usage.
  - Asset available for immediate sale
  - High probability of sale being taken place, less chances of change or withdrawal of plan
  - Possibility Sale to be completed within a year
  - Active efforts started
- **Disposal group.** A group of assets and possibly some liabilities that an entity intends to dispose of in a single transaction.

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- **What if the sale is not completed within one year?**

- It is possible that the sale may not be completed within one year. In this case, the asset could still be classified as held for sale if the delay is caused by events beyond the entity’s control and the entity is still committed to selling the asset

Example

Decide with Confidence

- An entity is committed to a plan to sell a building and has started looking for a buyer for that building
- The entity will continue to use the building until another building is completed to house the office staff located in the building
- There is no intention to relocate the office staff until the new building is completed

- Would the building be classified as held for sale?

Example

- An entity is planning to sell part of its business that is deemed to be a disposal group. The entity is in a business environment that is heavily regulated, and any sale requires government approval.
- This means that the sale time is difficult to determine. Government approval cannot be obtained until a buyer is found and known for the disposal group and a firm purchase contract has been signed. However, it is likely that the entity will be able to sell the disposal group within one year.
- Would the disposal group be classified as held for sale?

Important points

- Exchanges of noncurrent assets between companies can be treated as held for sale when such an exchange has a commercial substance
- If non current asset acquired for sale only (usually within one year but more than three months), it has to be classified as such under IFRS-5 on the same date of acquisition of asset
- If the criteria for classifying a noncurrent asset as held for sale occur after the balance sheet date, the noncurrent asset should not be shown as held for sale. Disclosures are necessary.
- Operations that are expected to be wound down or abandoned → to be classified as "disposal group" and not "asset held for sale"

Example

- An entity is reorganizing its business activities. In one location, it is stopping the usage of certain equipment because the demand for the product produced by that equipment has reduced significantly
- The equipment is to be maintained in good working order, and it is expected that it will be brought back into use if the demand increases. Additionally, the entity intends to close three out of five manufacturing units
- The manufacturing units constitute a major activity of the entity
- All the work within the three units will end during the current year, and as of the year-end all work will have ceased

The equipment will not be treated as abandoned as it will subsequently be brought back into usage. The manufacturing units will be treated as discontinued operations.

Measurement of assets held for sale

- Lower of
  - carrying value and
  - the fair value less selling costs
- Not to be depreciated
- Any interest or expenses of a disposal group should continue to be provided for
- In the income statement, the total of the after-tax profit or loss of the discontinued operation and the after-tax gain or loss recognized on the measurement to fair value less cost to sell (or on the disposal) should be presented as a single figure

Change of Plan

- If criteria not met, ceases to be classified as “held for sale”

should be valued at the lower of

carrying amount before the asset or disposal group was classified as held for sale (as adjusted for any subsequent depreciation, amortization, or revaluation)

its recoverable amount at the date of the decision

not to sell

- adjustment to the value → income from continuing operations for the period

Decide with Confidence

Accounting for Leases (IAS17)

Basics……

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- The lease is a contractual agreement between the lessor and the lessee.
- The lease gives the lessee the right to use specific property.
- The lease specifies the duration of the lease and rental payments.
- The obligations for taxes, insurance, and maintenance may be assumed by the lessor or the lessee.

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Outside the scope of the standard

- Property held by lessees that is an investment property (see IAS 40)
- Investment property provided by lessors under operating leases (see IAS 40)
- Biological assets held by lessees under finance leases (see IAS 41)
- Biological assets provided by lessors under operating leases (see IAS 41)

Decide with Confidence

- What is a lease?
- How do you classify the lease?
- When do you classify the lease?
- What if the agreement is renewed and the terms of the lease have changed?
- At what amount do you recognize the lease rentals?
  - In case of operating lease
  - In case of finance lease
- What differences did you notice between your reporting and your parent company reporting for lease accounting?

D&B Decide with Confidence

- How do you classify the lease in your balance sheet? (as a lessee)
  - Finance lease?? Operating lease??

- How do you classify the lease in your balance sheet?(as a lessor)
  - Finance lease?? Operating lease??

Criteria for finance leasing

- The lease ***transfers ownership*** of the asset to the lessee by the end of the lease term. (this would effectively be payment by installments)
- ***A bargain purchase option –*** (if an asset can be bought below its fair value)
  - Allows the lessee to buy the leased asset.
  - Usually, provides a financial incentive to purchase the asset.
- The ***lease term is for the major part of the economic life of the asset***, even if title is not transferred. (what is major part of the economic life?)

Criteria for finance leasing - 2

- At the inception of the lease, ***the present value of the minimum lease payments amounts to at least substantially all (?) of the fair value*** of the leased asset.
- The lease assets are of a ***specialized nature***. (Only the lessee can use them without major modifications being made, it's the lessee's asset)
- Gains or losses from fluctuations in the fair value of the residual fall to the lessee
- The lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent.

Example – identification of a lease

D&B
Decide with Confidence

- A company leases machine towers for to B co. for 4 years with annual payments of Rs. 10,00,000.
- At the end of the lease, the machine is returned to the lessor, who will set it for its scrap value. The appropriate interest rate is 6%.

- Is this a finance lease or an operating lease?
- How the treatment of the rental payments be considered?

Example….

A lease over machinery was entered into where the term of the lease was 30 yrs and the estimated economic life of the buildings was 45 yrs. This lease was classified as an operating lease. Now, at the end of the 30 yrs, the lease has been renegotiated and the new lease term is 20 years, which is equal to the revised estimated remaining life of these machineries.

Should the lessor and lessee account for this renewed agreement as for an operating lease?

Example- Land & Building

A lease involves both Land and Building. The classification of building is done as finance lease since it meets the criteria. However, title to land is neither expected to be transferred to the lessee nor the bargain purchase option exists.

In this case, how should Land be classified as.

How should the allocation of minimum lease payment at inception between the two be made?

Example- Land & Building

Decide with Confidence

- Generally, land and building are considered as separately for the purpose of lease agreements.
- Land is considered as an operating lease.
- However, Entire lease can be treated as finance lease, if the lease payments can not be reliably allocated between land and buildings and unless it is clear that it is an operating lease.
- If value of land is immaterial at inception, land and building can be treated as one unit.

Principles

Decide with Confidence

- Lease incentives
  - SIC 15 governs the accounting for lease incentives.
  - As per this, all incentives relating to new or renewed operating lease are to be considered while determining total cost of lease.

Types of finance lease

D&B Decide with Confidence

- Generally, a lease should be classified as finance or operating lease by both the parties in similar way.

- depending upon the terms and conditions a finance lease can be further classified as
  - i) Sales-type : the lessor recognises profit or loss on transaction in addition to interest revenue
  - ii) Direct Financing : This is a regular finance lease, in that the lessor does not recognize the profit or loss apart from interest revenue.
  - iii) Leveraged leases : In case of leveraged leases, apart from the lessor and lessee a long term creditor comes into picture who part finances the lease. The lessor in this case is called an equity partner

Accounting for lessors

Decide with Confidence

- **If the lease is a capital lease:**

1. recognize a sale
2. remove the asset from books and replace it with a receivable
3. treat rental receipts as consisting of interest and principal
4. Lessor records no depreciation

Accounting for lessor

Decide with Confidence

- **If the lease is an operating lease:**

-- record rental income for rental receipts (generally, on a straight line method) from lessee

-- asset held is shown in the balance sheet of the lessor

- Maintenance costs (payable by lessor) are charged as expense
- Costs, such as finder's fees and credit checks, are amortized over the lease term.
- The leased equipment and accumulated depreciation are shown as Equipment Leased to Others.

Accounting for lessees

- If the lease is a capital lease:

1. record an asset (leased equipment) and a liability (lease obligation) equal to the lower of present value of the rental payments and the fair value of the asset
2. record depreciation for the asset
3. Apportion lease rentals into interest and principal component

- If the lease is an operating lease:

1. do not record asset or liability
2. record rental expense as rental payments are made to lessor.

Disclosure Requirements: Lessor

Decide with Confidence

For the lessor, the requirements for operating leases:

- Cost and carrying amount
- Minimum future rentals
- Total contingent rentals
- General description of lessor’s leasing arrangements

Disclosure Requirements: Lessor

For the lessor, the requirements for direct financing leases are:

- Components of net investment
- Future minimum lease payments
- Amount of unearned revenue included in revenue
- Total contingent rentals
- General description of lessor's leasing arrangements

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Questions?

D&B

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Thanks for your participantion